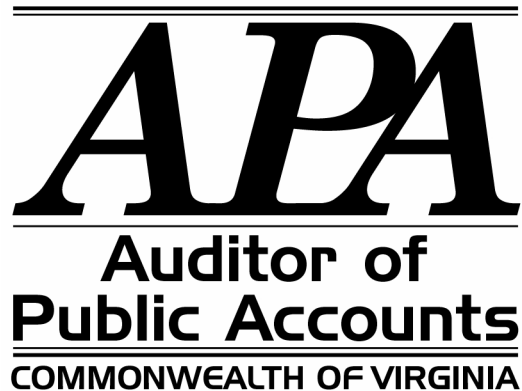


**SPEND ANALYSIS AND PROCUREMENT
CONSULTING SERVICES**

**SPECIAL REPORT
NOVEMBER 2003**



EXECUTIVE SUMMARY

General Services contracted with Silver Oak Solutions, Inc. (Silver Oak), for spend analysis and procurement consulting services. These services include analyzing the Commonwealth's purchasing data, developing an alternative procurement strategy to obtain better pricing and training contracting officers on the process.

FINANCING ARRANGEMENTS

During the eleventh month of the project, and almost four months after our initial request, General Services did not provide a financing plan. Because General Services did not provide the financing plan until the exit conference, we had no opportunity to review and incorporate the information into our report. As a result, we are unable to determine if the financing plan addresses the following issues; collection of rebate, incentive and surcharge payments, Silver Oak contract costs, or the financial impact on agencies and institutions.

The contract value including the three subsequent amendments is a not-to-exceed price of \$4,746,993. The contract guarantees estimated cost reductions at least two times the contract fees, or Silver Oak will reimburse the Commonwealth the amount necessary to make up the difference. As of August 30, 2003, General Services has paid Silver Oak a total of \$2,247,303 using \$610,031 in general funds and \$1,637,272 from nongeneral funds earmarked for the development and implementation of eVA. Of the total paid to Silver Oak, \$1,947,192 was for Phase 1 and \$300,111 for Phase 2.

As part of the procurement strategy, Silver Oak identified commodities that had the greatest potential for price reduction and suggested procuring these commodities using competitive negotiation. Historically, General Services and VITA procured statewide contracts for these commodities using competitive sealed bidding.

OTHER ISSUES

In performing our review, we have identified several key issues.

- With the new commodity contracts, General Services has estimated \$25 million in cost reduction through lower pricing. Since the new commodity contracts are optional, realized annual cost reduction may be much less than estimated. However, the possibility exists that the Department of Planning and Budget, the Governor, or the General Assembly may reduce agency budgets based on the estimated cost reduction calculation of \$25 million.
- By using competitive negotiation instead of competitive bidding, Silver Oak is using purchasing techniques that previous administrations did not consider preferred. While we noted some benefits, this approach also creates some shifts in procurement policy that General Services and others will need to monitor.

The new commodity contracts achieve lower pricing by means of reduced item pricing, discounts, rebates, and incentive payments. However, a system that generates a substantial portion of its cost reduction from rebates and incentive payments is highly dependent on a system that can monitor spending activity. A final issue is making sure that in the long-term, General Services can support that the process has generated a low cost for goods and services purchased by the Commonwealth. Maintaining this information is essential for both future contracts, and more importantly, monitoring contract compliance with the current vendor.

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November 25, 2003

The Honorable Mark R. Warner
Governor of Virginia
State Capital
Richmond, Virginia

The Honorable Kevin G. Miller
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have completed a review of the spend analysis and procurement consulting services obtained through a contract between the Department of General Services (General Services) and Silver Oak Solutions (Silver Oak).

Objectives

We had five objectives for our review. These objectives were to:

1. determine the purpose and the scope of the spend analysis and procurement consulting services provided by Silver Oak;
2. review the financing plan for the Silver Oak contract to determine its reasonableness and its effect on agencies and higher education institutions;
3. review Silver Oak's cost reduction calculations to determine their reasonableness and their effect on agencies and higher education institutions;
4. determine if the Silver Oak procurement strategy and methodology complies with the Virginia Public Procurement Act; and
5. compare the Silver Oak's procurement methodology and the methodology used previously by General Services and VITA, identify any differences, and determine if they represent a shift in statewide procurement policy.

Scope

In performing our work, we reviewed the original and modified contract with Silver Oak. We also requested and reviewed related procurement and contract files for the new statewide contracts to compare against previous procurements for the same commodities.

Additionally, we reviewed the Virginia Public Procurement Act to obtain knowledge on pertinent laws and regulations. Further, we reviewed the Agency Purchasing and Surplus Property Manual, which provides procurement guidance to agencies and institutions.

We also requested and reviewed various documents from Silver Oak related to the cost reduction calculation including baseline and cost reduction data.

We discussed this report with General Services' management at an exit conference on November 17, 2003. At the exit conference, General Services provided a financing plan and a memorandum of agreement between General Services and VITA.

Since the start of the review in July 2003 and eleven months after engaging Silver Oaks General Services finally provided the financing plan and the memorandum of agreement with VITA. Because we did not receive this information until after we had completed our report, we had no opportunity to review and incorporate the information into this report. We will be conducting a separate review of the financing agreement and plan on releasing the report in January 2004.

AUDITOR OF PUBLIC ACCOUNTS

MAM:whb
whb:25

SPEND ANALYSIS AND PROCUREMENT CONSULTING SERVICES

Introduction and Background

The Department of General Services (General Services) is the Commonwealth's central purchasing agency. General Services establishes the state policies and procedures for purchasing goods and services to ensure compliance with the Virginia Public Procurement Act. In addition, General Services establishes statewide contracts to assist agencies with the purchases of goods and non-professional services. State agencies and institutions have unlimited purchasing authority when using statewide contracts and for the purchase of services. On July 1, 2002, the authority for technology procurement transferred from General Services to the Department of Information Technology (DIT) now known as Virginia Information Technology Agencies (VITA). Public bodies, including towns, counties, localities and political subdivisions, do not fall under the procurement oversight of General Services. However, they are required to comply with the provisions of the Virginia Public Procurement Act. While localities may purchase from statewide contracts, their use is not mandated.

In general, the Commonwealth has decentralized procurement activities; however, in 2001, General Services implemented eVA, a web-based statewide e-procurement application. This is an initiative to the procurement process for all state and local government organizations within the Commonwealth and provides a means to gather information centrally concerning the Commonwealth's buying patterns. Additional information on eVA is contained in two separate reports dated May 31, 2002 and December 6, 2002.

In October 2002, the Secretary of Administration directed General Services to issue a competitive request for proposal for consulting services to provide spend analysis services. The contract for spend analysis services includes analyzing the Commonwealth's purchasing data, developing an alternative procurement strategy to obtain better pricing, and training contracting officers on the process. General Services awarded a contract to Silver Oak Solutions, Inc. (Silver Oak) on December 20, 2002. Silver Oak is a national firm that analyzes spend data and uses various procurement strategies to obtain better prices. The contract period of performance is from December 20, 2002 through June 30, 2003 with two options to extend. The contract value including the three subsequent amendments is a not-to-exceed price of \$4,746,993. The contract guarantees estimated cost reductions at least two times the contract fees, or Silver Oak will reimburse the Commonwealth the amount necessary to make up the difference.

Change in Procurement Strategy

Through analysis of purchasing data, Silver Oak identified nine commodities that had the greatest potential for price reduction. On December 20, 2002, Silver Oak and General Services agreed on the selected Phase 1 commodities listed below, with the exception of lab supplies and temporary services, agreed to in March 2003.

- Computer Hardware
- Office Supplies
- Paper
- Janitorial Supplies
- Lab Supplies
- Uniforms

- Software
- Temporary Services – Clerical & Labor
- Maintenance, Repair and Operating (MRO) Supplies

While most Phase 1 commodities deal with procurement areas for which General Services is responsible, two of the commodities deal with information technology procurement for which VITA is responsible.

Historically, General Services and VITA procured statewide contracts for these commodities using competitive sealed bidding. This method requires vendors to submit sealed bids based on the specific scope, qualifications, terms, and conditions stated in an Invitation for Bid. Competitive sealed bidding generally results in one round of bidding with no negotiation, and price is the determining factor for vendor selection.

As part of their procurement strategy, Silver Oak suggested using competitive negotiation as the desired procurement method for the Phase 1 commodities. Since competitive negotiation allows for multiple rounds of negotiation, Silver Oak felt this method would provide more opportunities to obtain lower pricing. This procurement method uses other factors besides price to determine vendor selection, including delivery requirements and product substitution. Both General Services and VITA made determinations to use competitive negotiation as the procurement method for all Phase 1 commodities.

Further, Silver Oak's analysis identified the most heavily purchased products for each commodity, and used this information in developing their procurement strategy. While statewide contracts were already available for all nine commodities, most of these commodities had multiple contracts, each for specific products. The specifications in the Phase 1 commodity RFP's allowed vendors the flexibility to propose different product mixes or substitute products in responding. Silver Oak also thought the vendor would respond with lower pricing as a result of responding to an increased product mix in a single contract as opposed to multiple individual contracts for specific items. Vendors sent their Phase 1 proposals in April 2003. General Services awarded and made available fifty-three contracts for Phase 1 commodities in October 2003.

Some of these contracts contain a surcharge provision that requires vendors to pay General Services 2 percent of sales. General services plans to use this revenue to defray the costs for future procurements, subsequent awards, and analysis of purchasing data. This charge is similar to the 2 percent surcharge charge already in place for some goods and services procured through VITA to defray costs for procuring and administering the respective contract. For the Phase 1 commodity contracts administered by both General Services and VITA, General Services will collect the surcharge and transfer a portion to VITA. However, since no Memorandum of Understanding exists between General Services and VITA as of October 27, 2003, we are unable to determine the surcharge allocation amounts.

The new commodity contracts primarily achieve lower pricing through reduced item pricing. The new unit prices are lower than the Commonwealth was able to achieve under previous statewide contracts. Additionally, some contracts include rebates, incentive payments, and discounts. Some suppliers offered rebates, incentive payments, and discounts based on the Commonwealth's purchasing volume or having the Commonwealth agree to longer contract periods. General Services will receive all rebates, incentive payments, and discounts from the vendors, with the primary cost reduction mechanism available to agencies being the reduced item pricing.

Since one would expect that the provision of rebates and incentive payments negatively affect unit pricing, one would also assume that agencies are not receiving the lowest possible price. In fact, General Services requested vendors with the 2 percent surcharge to increase their original quoted prices 2 percent. General Services will use the 2 percent surcharge to cover the costs of Silver Oak's services.

Phase 2 Commodities

Silver Oak received a third modification to their contract on July 10, 2003, to expand the project (Phase 2) with an additional cost of \$2,788,031. The amended contract includes spend analysis for the additional nine commodities listed below and spend and baseline monitoring for the first nine commodities in phase 1. In addition, Silver Oak will perform an analysis on the commodity of "Disaster Recovery" to determine the potential to obtain lower pricing. Silver Oak will also provide training to agencies and institutions so that they perform the procurement data analysis and use the analysis for the procurement and negotiation process. The third modification has an expected completion date of February 10, 2004.

Project Phase 2 Commodities:

- Printers
- Other PC Accessories
- Enterprise Storage Devices
- Storage Media
- Heavy Trucks
- Off-Road Equipment
- Grounds Maintenance Equipment
- School Buses
- Airlines
- Travel Agency
- Hotels

Further, Silver Oak will be responsible for monitoring and evaluating actual total dollars spent and cost reductions achieved over time. Reports available from this effort will allow General Services to identify how much agencies and higher education institutions are using eVA and the new contracts procured through the spend analysis effort.

Financing Plan

Although the project is in its eleventh month General Services has no financing plan that addresses the following issues; collection of rebate, incentive, surcharge payments, Silver Oak contract costs, or the financial impact including potential cost reduction calculations on agencies and institutions.

Currently, the contract with Silver Oak represents an almost \$5 million obligation for the Commonwealth. As of August 30, 2003, General Services has paid Silver Oak a total of \$2,247,303 using \$610,031 in general funds and \$1,637,272 from nongeneral funds earmarked for the development and implementation of eVA. Of the total paid to Silver Oak, \$1,947,192 was for Phase 1 and \$300,111 for Phase 2.

For eVA implementation, General Services established an enterprise fund to record related financial activity including revenue collection for vendor fees and payment of expenses. For fiscal year 2003, the General Assembly temporarily ceased vendor fees as a source of revenue and instead required General Services to collect money from each agency and institution as the primary source of funding. In addition, the General Assembly authorized a treasury loan to pay for the costs of developing and implementing eVA.

During the initial phase of the Silver Oak project, General Services proposed to pay for the cost of consultant services using the treasury loan available for eVA implementation and repay the loan through surcharges received from vendors. General Services justified the use of these funds for the spend analysis effort as reasonable towards the development and implementation of eVA. Because funds were available, General Services paid Silver Oak using the funds collected from agencies and institutions and earmarked for the development and implementation of eVA. With expenses related to both eVA and the spend analysis project exceeding available funding, as of August 30, 2003, General Services has obtained \$2.5 million in treasury loans. In order to avoid compromising the full and complete implementation of eVA, General Services intends to reimburse these funds through vendor's surcharge payments. However, as of October 29, 2003, General Services has not completed a financing plan, which explains how they will do this.

Further, entering into the commodities contracts without a financing plan creates uncertainties and risks for all stakeholders involved. While General Services has expressed how they intend to account for surcharges, we have not determined their accounting of the allocation or the treatment of rebates and incentive payments. In addition, if payments are insufficient, agencies and possibly institutions could be responsible for paying the difference. The Appropriation Act gives General Services the authority to recover from nongeneral fund agencies their share of maintaining the statewide systems if an agency or institution is not executing the majority of its procurements utilizing the electronic procurement system. It is uncertain as to whether the cost for Silver Oak constitutes part of the costs of maintaining a statewide system.

However, General Services does consider the cost for Silver Oak as part of the costs of maintaining a statewide system. As a result, without a financing plan, agencies and institutions may not be aware of their portion of total expenses and possible budgetary impacts.

Recommendation #1: Develop a financing plan

General Services should develop a financing plan to determine the feasibility of a full cost recovery of the cost of the Silver Oak contract prior to obligating almost \$5 million. In addition, General Services should determine and communicate any impact that the financing plan and collection of any fees will have on agencies and institutions so that they are aware their share of the total cost, if any and subsequent budgetary impact.

Exit Conference

General Services provided a financing plan and memorandum of agreement with VITA at the final exit conference on November 17, 2003. However, because we did not receive the plan until the exit conference, we cannot determine if the financing plan addresses the issues in the recommendation for the purposes of this report.

Cost Reduction Calculations and Impact on the Agencies/Institutions

Reducing costs is dependent on the agencies' and institutions' use of the statewide contracts procured through Silver Oak process. At approximately the same time as the Silver Oak contract award, the Commonwealth established the Virginia Partners in Procurement as a mechanism to encourage agencies and institutions to use the new commodities contracts procured through Silver Oak.

Based on the new commodity contracts, the Commonwealth has calculated an estimated cost reduction of \$25 million.

Since the use of these statewide contracts is optional, agencies and institutions may make purchases outside of these contracts. For instance, there are nine universities with decentralized unlimited procurement authority, which makes the use of statewide contracts "preferred." Further, these universities, as a group, procure their own contracts, which provide benefits including lower prices and items tailored to university needs.

At this time, General Services has not compared new commodity contracts with the university procured contracts to determine if they will be more beneficial for the decentralized universities. In order to realize cost reductions, the new commodity contracts must provide benefits to the decentralized institutions in order to maximize their use.

Consequently, realized annual cost reduction may be much less than the Commonwealth's estimated annual cost reduction of \$25 million. While the estimated cost reduction calculation satisfies the guarantee set forth in the contract, the bigger issue is what the Commonwealth plans to do with this information. The possibility exists that the Department of Planning and Budget, the Governor, or the General Assembly, may reduce agency budgets based on the estimated cost reduction calculation.

Future Issues Requiring Resolution

Silver Oak will monitor spend and calculate the actual cost reductions as well as develop the reports used to determine the calculation. Only through maximum use of these contracts will the Commonwealth achieve true cost reductions. General Services should continue their efforts to increase participation of agencies and institutions including involving major university participation such as in user groups. No Memorandum of Understanding exists between General Services or VITA. As a result, we are unable to determine the fiscal and operational responsibilities required of each agency. General Services has developed no methodology to support cost reductions that may impact individual agencies.

Monitor Policy Change

By using competitive negotiation instead of competitive bidding, Silver Oak is using purchasing techniques that previous Administrations did not consider preferred. Additionally, while working within the Virginia Public Procurement Act (Procurement Act), the approach used with the Silver Oak contract creates some shifts in procurement policy that General Services and others will need to monitor.

The Procurement Act arose from questionable procurement activities within the Commonwealth in the mid-1970's. The negotiation of contracts and prices without clear competition or openness lead to the creation of the Procurement Act. The Procurement Act clearly places preference on competitive bidding and requires written justification to proceed with a procurement method other than competitive sealed bidding for the purchase of goods and nonprofessional services. The approach using multiple rounds of competitive negotiation for purchasing goods redefines competition.

Procurement through competitive negotiation generally consumes more resources as compared to competitive bidding due to additional steps in the negotiation and evaluation process. As a result, General Services instructs agencies to justify the use competitive negotiation when it is not fiscally advantageous or practicable to develop concise specifications required for competitive bidding. As a result, it is often easier and more efficient in the short term for agencies to generate multiple competitive bidding procurements for specific products.

However, the contracts procured through Silver Oak illustrate that there may be benefits to using competitive negotiation by procuring a product mix. First, the process would be more efficient by procuring multiple products with one procurement event. In addition, multiple rounds of negotiation provide more opportunities to obtain better pricing. Further, flexibility in evaluation criteria allows consideration of other factors besides price.

Some risks do exist. Offering a product mix may inadvertently be more advantageous to larger vendors, and negatively impact smaller vendors including women and minority owned businesses. Also, the use of competitive negotiation can cause questions concerning a product unit cost, especially where the contract provides for rebates and incentive payments. Since the rebates and incentive payments do not accrue to the purchaser, but the Commonwealth as a whole, agency purchasing officers may look to other sources for products. Additionally, individual agencies may find spot market unit prices cheaper for a commodity, because the standing contract is part of a product mix.

The final issue is making sure that in the long-term, General Services can show that the process has generated a low cost for goods and services purchased by the Commonwealth. Maintaining this information is essential for both future contracts and more importantly monitoring contract compliance with the current vendor. A system that generates a substantial portion of the saving from rebates and incentive payments is highly dependent on a system that can monitor spending activity. If General Services cannot capture information to determine that the Commonwealth has earned a rebate or incentive payment and received the money, then the Commonwealth has not benefited from this process.



COMMONWEALTH of VIRGINIA

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November 18, 2003

Mr. Walter J. Kucharski
Auditor of Public Accounts
P. O. Box 1295
Richmond, VA 23218-1295

Dear Walt:

Thank you for the opportunity to preview your report, Spend Analysis and Procurement Services, for meeting with us, and considering our comments on two previous drafts.

We believe the information set forth in the report is substantially accurate, and have no additional comments to offer at this time. We look forward to working with you on follow-up reports, and other matters of mutual interest.

Sincerely,

A handwritten signature in blue ink, appearing to read "James T. Roberts".

James T. Roberts
Director